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SUBJECT: DPRK ECONOMY: KAESONG INDUSTRIAL COMPLEX, BOOM OR
BUST?

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SUMMARY

¶1. (SBU) A round of discussions with South Korean companies operating in the Kaesong Industrial Complex (KIC) in North Korea revealed that most are generally satisfied with business conditions at the project site. While most firms profess to be making money or to be on track with their business plans, at least one is struggling, although not necessarily because of factors unique to the KIC. While most South Korean companies operating in the KIC appear to have only a small part of their overall business riding on their North Korean operations, others look like they are betting their future on KIC success.

¶2. (C) North Korean workers are reported to be capable, reliable, and amenable to changing requirements. Some employers are able to manage their workers directly, while others work through DPRK intermediaries. While no concrete figures are available, it appears that the total monthly labor payment for KIC -- for some 4,200 North Korean employees -- totals around USD 242,000. At USD 57.50 per person per month, cheap labor seems to be the single most attractive feature of the KIC for South Korean investors.

¶3. (C) Some investors calculate that North Korean workers are about half as expensive as Chinese laborers, while their productivity is about 70-80 percent of the Chinese level, making the DPRK workers a relative bargain. Another frequently-cited advantage of the KIC location is its proximity to South Korean markets, allowing for completion of last-minute orders.

¶4. (C) If KIC employees can serve as a metric for the DPRK population in general, the overall DPRK food situation seems to have improved over the last few years. KIC workers appear to consider employment at the complex to be prestigious and valuable work, and the workers express appreciation for the fringe benefits they receive. No KIC employers, however,

know the answer to the question of how much of their monthly wage payments actually makes it into the pockets of KIC workers; the employees themselves are forbidden to discuss the topic with South Koreans. End Summary.

WE ASKED KIC FIRMS: "HOW'S BUSINESS?"

15. (SBU) Econoff recently met individually with executives from four companies active in the KIC: Romanson Corporation, ShinWon Corporation, SoNoKo and SJ Tech. These companies represent a cross-section of the South Korean companies involved in the Pilot Phase of the KIC development. Of the 15 companies selected for the pilot phase, 11 companies have commenced operations, two are about to start operations, and two are awaiting the completion of their facilities.

16. (U) The other seven companies currently operating in KIC are Samduck Trading (footwear), Buchon Industrial (wiring harnesses), Daehwa Fuel Pump (automotive parts), Hosan Ace (coils), Munchang Company (garments), Taesung Industrial (plastic containers) and JY Solutech (moldings). The two companies poised to commence operations are Magic Micro (electronics), and TS (moldings). The facilities of Youngin Electronics (electronics) and JC Com (cable connectors) facilities are scheduled to be completed soon.

17. (SBU) The Ministry of Unification (MOU) is in the preliminary phases of selecting an additional 23 companies to invest in another small sub-section of the grand First Phase of the overall project -- essentially a second pilot phase. Construction of those facilities can be anticipated to get started within 2006, although that ambitious goal could slip. According to press reports, MOU is also eager to move forward as soon as possible with the full First Phase of the KIC, which could incorporate as many as 40 additional factories, bringing the total to roughly 78 firms operating in the KIC, of a variety of sizes. Site preparation construction work is currently ongoing for the full scope of the First Phase. Some firms might begin to establish factories as part of that effort within 2007 -- again an ambitious goal, which could prove elusive.

SHINWON GARMENTS: "PROFIT IS ALWAYS IN STYLE"

18. (SBU) ShinWon is a large garment manufacturer that has been listed on the Korea Stock Exchange since 1988. The company's 2004 sales were USD 367 million, and in the first half of 2005, its reported sales totaled more than USD 150 million. ShinWon is an international company, with factories located in South Korea, China, Vietnam, Guatemala and Indonesia. The company has operated its KIC facility since February 2005. According to Lee Chang-yoon, President and CEO of ShinWon's Domestic Division, the value of the company's investment in KIC is approximately 4.5 million dollars.

19. (SBU) ShinWon seems to have a successful business plan for its KIC operations, and Lee asserted that his company is in the KIC solely for business reasons. In addition to the lower labor costs, manufacturing in the KIC also lets ShinWon avoid tariffs on shipments back to South Korea, and provides the company with a quick solution to meet surges in demand. ShinWon's KIC plant accounts for seven percent of the company's total production. All of the KIC-produced apparel is sold in South Korea. While the company's first fashion show -- held at KIC -- achieved some notoriety for featuring clothing that was reportedly too flashy for North Korean taste, an informal survey of our FSN staff indicates that ShinWon's KIC-manufactured lines are acceptable for the fashion-conscious South. Most of ShinWon's designs are targeted towards young South Koreans.

110. (SBU) ShinWon currently runs its KIC facility with only seven ROK managers supervising 330 DPRK workers. According to Lee, because of the workers' productivity and the low labor costs, Shinwon plans to expand its KIC facility, from

the current five assembly lines to 15 lines by the end of February 2006. The company also plans to hire an additional 500 North Korean workers to staff the new lines. While Lee opined that the oft-heard estimates of 100,000 workers at KIC by 2007 could be met in the fullness of time, he scoffed at future estimates of 1,000,000 workers that have been suggested by former Unification Minister Chung and various officials at Hyundai Asan Corporation, which is doing most of the infrastructure work at KIC.

¶11. (SBU) According to Lee, ShinWon is the only South Korean firm currently making money through operations at KIC. He would not provide exact figures, but claimed that the KIC labor costs are less than half those at ShinWon's Chinese plants. KIC companies must pay a minimum of USD 57.50 per worker per month. That payment is composed of USD 50.00 for the wage component, and USD 7.50 as a social welfare contribution. Additionally, all KIC companies provide a daily lunch or soup, and some use other material items as incentives for the employees. Still, according to Lee, KIC workers are currently only about 70-80 percent as productive as their Chinese counterparts. He described the North Korean workers as "naive but well-educated," and asserted that KIC worker productivity is certain to increase.

¶12. (SBU) Lee claimed that nearly 40 percent of the (predominantly female) labor force at his plant has graduated from university. He also noted that when ShinWon first began hiring at the KIC plant, the applicants were mostly in their twenties, but now the applicant pool appears to be growing older, with some applicants in their forties. As other employers told us as well, Lee claimed that there is almost no turnover among ShinWon's KIC workers.

¶13. (SBU) ShinWon's KIC managers directly supervise their workers, according to Lee. He explained that there are no DPRK intermediaries who get involved in work schedules or requirements, but ShinWon does deal with workers' representatives on issues such as fringe benefits. Lee said that ShinWon is widely acknowledged as providing more benefits than most of the KIC companies, including shower facilities and generous distribution of food, in addition to the lunch provided by most KIC companies.

¶14. (C) When asked about the amount workers actually receive from the nominal monthly wage, ShinWon's Lee told us that he did know the take-home wages of his KIC employees. He explained that DPRK authorities have explicitly forbidden discussions on that topic, and that even if asked, the North Korean workers will not answer. Lee complained that ShinWon wants to set up its own payroll system, and has asked permission to do so from the DPRK authorities, but they have been denied permission.

¶15. (C) Before Woori Bank opened a branch office in the KIC in December 2004, ShinWon -- like the other South Korean companies -- held off on making payments to North Korean authorities. Since then, payments for worker salaries have been made in U.S. dollars to the Central Development Special Bureau office in the KIC. ShinWon also paid in full their "arrears" to the DPRK authorities. According to South Korea's Ministry of Unification, individual companies withdraw dollars themselves at the KIC Woori Bank facility, then transfer the funds to the DPRK-run liaison office. With an estimated 4,200 North Koreans working in the various KIC factories at this time, and a minimum monthly wage of USD 57.50, monthly cash payments made through the bank total approximately USD 242,000.

ROMANSON WATCHES: "CAN'T EVEN GIVE 'EM AWAY"

¶16. (U) Romanson Corporation sells watches and jewelry, largely creating new designs in-house and jobbing out orders to plants around the world. Most of the products are sold in Russia, other former Soviet Republics and countries around south and north Asia. Among the companies we visited, Romanson seems to be the most unlikely model for a profitable

venture. As explained below, many of their decisions are puzzling when viewed in a business context. End comment.

¶17. (SBU) The KIC plant is run through a consortium of investors led by Romanson. Romanson executive director Jang Ho-sun explained that the consortium started work on its KIC plant in January 2005, and began manufacturing operations in August. The consortium was put together to take advantage of KIC's low labor costs, according to Jang. He noted that there were no ideological or political reasons driving the decision to establish a facility in the KIC.

¶18. (SBU) Jang, like ShinWon's Lee, told us that the cost of labor at the KIC plant was roughly half that of his company's Chinese plant. However, much of what Romanson saves in reduced labor costs may be lost in the cost of maintaining a large number of South Korean managers at its KIC facility. The company has one of the highest South Korean manager-to-DPRK worker ratios we encountered, with 80 managers supervising 560 workers. In addition to South Korean-level wages, most companies must pay a "risk" premium to their South Korean managers -- as well as per diem and transportation costs -- for working at the KIC. All South Korean managers commute for varying periods from Seoul to Kaesong.

¶19. (SBU) While there are no plans to increase the size of Romanson's KIC facility, Jang predicted doubling his labor force to 1,000 workers. Increasing the number of employees at this stage seems to be yet another counter-intuitive move by Romanson, as Jang lamented that, as a company, the firm is not meeting overall revenue targets. However, he professed confidence that the company's sales will increase, especially the KIC-made watches.

¶20. (SBU) According to company officials, Romanson's annual sales are approximately 900,000 watches, of which 25 percent are currently produced at its KIC facility. Company officials hope to increase KIC-produced sales to 50 percent of the total this year, and to 80 percent within two years. Jang did not elaborate on whether Romanson would concurrently reduce other overseas production if KIC production met these goals.

¶21. (C) Following the meeting with Jang, Econoff stopped at the in-house store located in Romanson's building. When the store clerk was asked about a garish set of commemorative watches, she explained that the set of watches -- named "tong-il," or unification -- was made to mark the beginning of operations at Romanson's KIC plant. Three nine-watch sets, encased in a traditional Korean lacquered box, were produced for the occasion. One set was presented to DPRK leader Kim Jong-il, one to South Korean President Roh Moo-hyun, and the last set was presented to, but declined by, an unnamed South Korean cabinet minister, according to the clerk. We assume this unnamed minister to be former Unification Minister Chung Dong-young.

¶22. (SBU) According to Jang, Romanson's KIC managers are not permitted to directly supervise their DPRK employees. Instead, they supervise the work force through a layer of North Korean managers. As all the companies do, Romanson pays its workers the minimum wage, and company officials claimed they make no other payments or "contributions" to DPRK officials in order to run their plant. Jang was satisfied with the quality of his DPRK employees, explaining that the workforce was stable, and that only two have left since the Romanson plant opened.

¶23. (SBU) In Jang's opinion, the food situation in the DPRK must have improved. He told us that when North Korean workers began reporting to Romanson's factory last fall, they appeared to have visual symptoms associated with malnutrition. Jang commented that the faces of those first employees were ashen, but that more-recently-hired employees are in better shape and do not appear to be suffering from nutritional problems. We were shown photographs of the various KIC plants at most meetings. The North Korean

workers all appeared robust and seemed to be in good shape.

SJ TECH PUMP SEALS: "MORE THAN JUST MANUAL LABOR"

¶24. (SBU) SJ Tech claims to have been the first South Korean company to sign up for the KIC -- in September 2004 -- and in fact, the building address is 1-1 Kaesong Industrial Village.

According to company president Yoo Chang-geun, SJ Tech was contemplating a joint venture operation with a U.S. manufacturer in 2004. The two companies were originally thinking about expanding into China, but decided on KIC instead. While Yoo was originally uninterested in KIC, he changed his mind because of the low cost of labor, the common language, and the South Korean government's investment guarantee -- with a ceiling of 2.5 million dollars at the time.

¶25. (SBU) Since that initial decision, SJ Tech has invested USD 8 million in its KIC plant to date, nearly double the amount covered by South Korean government guarantees against political risk for investment in KIC. In January 2006, the South Korean government increased the guarantee to five billion won (approximately USD 5 million). In comparison, non-KIC South Korean companies are covered up to one billion won against political risk for investments elsewhere in the DPRK. Yoo's company produces a range of industrial products, but its KIC plant produces rubber rings used in hydraulic seals. Yoo explained that all inputs for KIC operations are sent from South Korea, and that final assembly of the hydraulic seals takes place in South Korea.

¶26. (SBU) SJ Tech's KIC operations require a degree of technical expertise. Therefore, the company asked DPRK authorities to recruit employees with technical backgrounds or training. Despite the fact that nearly half of the new employees showed up with a technical degree, SJ Tech reportedly had to train them for nearly one year before they could begin full-scale production. In comparison, Yoo told us that SJ Tech's South Korean workers require only a five-month session to receive equivalent training. While most anecdotal accounts of KIC operations include the assertion that the South Korean firms only use low-tech, outdated, or worn-out equipment in Kaesong, during our visit Yoo showed a flashy PowerPoint presentation on SJ Tech's KIC operations. The equipment featured in the presentation appeared to be modern, functioning and well-maintained.

¶27. (SBU) According to SJ Tech's projections, the KIC factory will reach the break-even point sometime in 2007. According to Yoo, only five percent of SJ Tech's overall sales come from its KIC operations, and the seals produced there are sold only in the domestic South Korean market. SJ Tech's DPRK labor force has 143 workers, with five South Korean managers -- down from the 20 they started with in May 2005. While he does not have plans to expand his KIC operations, Yoo told us that he is happy with his decision to invest there. Among the executives we met, Yoo was the most tight-lipped about KIC salaries and benefits. He comes across as a savvy businessman who is concerned only about the bottom line.

SONOKO CUISINEWARE: "WORKERS LOVE THE BENEFITS"

¶28. (SBU) Kim Suck-chul, owner of SoNoKo Cuisineware, formerly known as LivingArt, is a gritty businessman with three decades of experience in the kitchenware business. SoNoKo (derived from "South and North Korea") is the restructured version of LivingArt, which was dissolved when Kim's partner failed to make promised investments. According to Kim, this unnamed partner asked him to participate in the KIC venture because of his extensive experience. Kim claimed to have invested USD 3.5 million of his own money and said that he had taken a USD 2.3 million loan from the Inter-Korean Cooperation Fund. Kim did not elaborate on the unnamed partner's contributions.

¶29. (SBU) The LivingArt company was the first to bring KIC-produced goods to South Korea for sale. In fact, its first run of KIC-made kitchenware -- simple pots and pans -- was an instant sentimental hit in South Korea, selling out as part of a flashy promotional event at the prestigious Lotte Department Store on the first day. The company's 2005 sales totaled USD 2 million, all in South Korean sales. Since then, the KIC plant had to suspend operations for an extended period in 2005, and is currently operating at reduced capacity. While Kim conceded the going remains rough, he claimed that he is starting a second production line at his plant. SoNoKo's products are currently sold in Mexico because of his "long-standing contacts and experience there," but Kim spoke longingly of his target market -- Europe. Kim claimed that there would be no problems with "rules of origin" or "made in Kaesong" labels in the European markets.

¶30. (C) Kim explained to us that, because his was the first company to actually talk with DPRK officials about operating in the KIC, he had a difficult time, and he complained that he had received little support from the South Korean government. Kim went on to tell us that because of these problems, he suffered delays in the start of production at his KIC plant resulting in his failure to produce samples for trade shows in early 2005, denying him any significant international sales that year.

¶31. (SBU) Kim explained that he would soon be traveling abroad to display his KIC-made kitchenware at this year's trade shows. He claimed that if he could get "USD 30-45 million worth of orders," at these trade shows, he could operate at full capacity and produce nearly 200,000 sets of kitchenware per year. That, he told us, would allow him to turn the company around and make a profit.

¶32. (SBU) SoNoKo's operations are limited to its KIC factory, with 380 DPRK workers and seven South Korean managers. The ratio was originally 270 to 13, but Kim explained that increased productivity from the DPRK workers permitted a reduction in the number of more expensive South Korean employees. According to Kim, when the DPRK workers first started, their productivity level was about 20 percent of South Koreans in the 1970's and 1980's, when a viable South Korean kitchenware industry last existed. Kim estimated that his workers at KIC are now up to about 60 percent of the ROK productivity level.

¶33. (SBU) SoNoKo's managers also deal directly with their DPRK employees, and Kim told us that requests to work overtime are handled painlessly. According to Kim, overtime is booked at time-and-a-half, with settlements made along with the regular monthly wage payments. Like the other companies, SoNoKo's main form of compensation given directly to the employee -- usually for overtime work -- seems to be providing extra food or other material reward.

¶34. (C) Kim, like the other executives we interviewed, told us that he has no idea how much of the cash monthly wage paid to the DPRK authorities is actually taken home by his workers. Unlike the others, Kim speculated that it could be possible that the workers receive no pay at all out of the monthly payments. But, he added, even if the workers are getting no pay at all, they are probably content "just to receive food, clothing, and a comfortable working environment, in addition to housing provided by the DPRK."

¶35. (SBU) Like Romanson's director Jang, Kim believes that the food situation has improved in the DPRK. He recalled that when the plant first opened, his North Korean workers were adding barley to their rice at lunch to make the meal go further. Now, they bring only rice in their boxed lunches, indicating that they are somehow getting more food -- either through the Public Distribution System or through market purchases.

COMMENT

¶36. (U) Although admittedly a second-hand look, our interviews revealed that KIC profitability neither lives up to the very rosy view of some South Korean champions of greater inter-Korean cooperation, nor falls within the dismissive "wasted investment" view of some Seoul-based critics of North-South engagement. Although there are signs that some KIC investment decisions are driven by sentimentality or a desire to accelerate reunification, we also gained the impression that the majority of the businessmen directly involved in KIC work are making credible business decisions, motivated primarily by hoped-for profits.

If reports of increasing levels of productivity are accurate, it is possible that the KIC's North Korean labor force could provide South Korean companies a lucrative option relative to outsourcing from China, fairly soon. In short, however, it remains to be seen whether the KIC can be declared a business success.

¶37. (C) There are signs that some North Korean citizens are being exposed to market principles in the KIC to some degree or another, and that a limited number of workers are learning advanced work skills. As they receive decent treatment and tangible fringe benefits from their South Korean employers, at least those North Koreans working in the KIC may be starting to understand the economic value of their work.

VERSHBOW